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# Supreme Court of the United States

**OCTOBER TERM, 1935**

**No. 8**

JAMES C. COLGATE,

*Appellant,*

*vs.*

ERWIN M. HARVEY, Tax Commissioner of the State of Vermont,

*Appellee.*

APPEAL FROM THE SUPREME COURT OF THE STATE OF VERMONT.

## APPELLANT'S BRIEF IN REPLY.

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## Difference Between the Positions Taken by the Vermont Supreme Court Below and by the Tax Commissioner in This Court.

The Commissioner's brief goes much farther in argument to justify Vermont Public Act No. 17 of 1931 than the Vermont Supreme Court did and makes one point not anticipated by the appellant's brief.

The Vermont Supreme Court refused to pass upon the Commissioner's argument of equality in support of the exemption from taxation of interest on Vermont loans at not more than 5%, and instead boldly upheld it as a deliberate and proper attempt to keep Vermont money invested in Vermont. Its language was as follows (R. 24):

> "There is no constitutional infirmity in the exemption of five per cent Vermont loans. Opinions of Justices of New Hampshire, supra. The state argues that this is but an extension of a settled state policy. But we prefer to put our decision on the broad ground that a state may, in the interests of thrift and state development, make such reasonable exemptions as this. That it may so encourage its taxpayers to keep Vermont money invested here for the assistance of the agricultural and industrial interests of the state."

The Vermont Supreme Court did not mention the disparity between the 2% tax on intra-state corporate earnings and the 4% tax from which intra-state dividends are exempted but we assume that its justification would be the same—the deliberate legislative purpose of keeping Vermont money invested in corporations earning their dividends in Vermont.

The Vermont Supreme Court's view of the intention of the Legislature is unquestionably correct. The Vermont statute is framed with the obvious deliberate purpose to "encourage its taxpayers to keep Vermont money invested

here for the assistance of the agricultural and industrial interests of the state'' by discouraging them from investing Vermont money elsewhere. The statute encourages taxpayers to invest in Vermont and discourages them from investing elsewhere, by exempting from income tax the interest on 5% loans made in Vermont and the dividends from corporations engaged in business in Vermont and by taxing the interest on such loans made outside of Vermont and the dividends from corporations engaged in business outside of Vermont.

That is the purpose of the statute as admitted by the Vermont Supreme Court. The Commissioner in his brief in this Court (pp. 21-22), beside citing cases and argument intended to support this view of the Supreme Court and to justify a statute designed to discriminate in favor of local investment, goes on to take a completely inconsistent view of the intention of the Legislature and to attempt to justify the statute as the legitimate instrument of that intention.

This inconsistent view of the intention of the Legislature which the Commissioner takes in this Court is that the intention of the Legislature was to bear down equally upon extra-state investment and intra-state investment. Indeed, the Commissioner takes still a third position and says that the burdens carried by intra-state investment are greater than those imposed by the statute upon extra-state investment.* If equality or favor to out of state investment was the intention of the Vermont Legislature, it was so well concealed that it escaped the detection of the Vermont Supreme Court and it certainly escapes our detection.

The Commissioner's attempt to demonstrate that extra-state investment is treated better than intra-state is based upon an argument which was not anticipated in our principal brief. The argument is, in short, that there may be cases where the capital which produces the income which is exempted from tax may have borne an *ad valorem* prop-

*Appellant's brief, p. 26.

erty tax in Vermont and that this justifies the exemption of the income from income tax. The path of reasoning by which it is sought to reach this result is most tortuous, but since the Commissioner in his brief in this Court has attempted to follow it, we perforce must follow him to demonstrate that it does not lead to a justification of the statute. By doing so, however, we do not wish to appear to abandon our position which accords with that of the Supreme Court of Vermont, that the statute is designed to and does place a greater tax burden upon extra-state income than upon intra-state income. Our opponents taunt us with our concession that this intention of the Legislature was an extremely logical one. To our view, a statute which works a discrimination against out-of-state investments with deadly and inescapable logic is more to be condemned than one which works a capricious discrimination because of its lack of logic.

## The Commissioner's Attempt to Justify the Exemption of Vermont Interest from Taxation.

The Commissioner's brief first attempts to justify the exemption from taxation of interest on Vermont loans at not more than 5% by invoking the history of the language used in the statute. We are told that that language was once used in a statutory scheme of taxation which contained no illegal discriminations. However, a respectable past is not enough to justify a statute which in its present form works discriminations. The present situation is therefore the only one which we need consider.

As we understand the Commissioner's position as to the present situation, it is that money loaned in Vermont at not exceeding 5% interest *may be** invested in tangible

* There is no foundation to the claim in Footnote 10 on page 18 of the Appellee's Brief that the creditor does not obtain tax exemption on the interest on Vermont loans except where the borrower invests it in Vermont. The Vermont Supreme Court did not so construe the statute. The form supplied by the state (R. 6B) permits the listing of "Interest on Money loaned in Vt. at 5% or less" as non-taxable. It, of course, would be a practical impossibility to trace the money loaned as between a borrower's expenditures for investment and for other purposes.

property* which *may be* located in Vermont and therefore subject to a property tax. We shall refer to such a property tax, measured by the value of the principal, as a capital tax, to distinguish it from the income tax and franchise tax, measured by income, with which we are now dealing. The argument of the Commissioner is that the interest which the statute in terms exempts from income tax is likely to be interest upon money borrowed and used by the borrower for the purchase of property subject to a capital tax, and that when any property so bought bears the burden of this capital tax, that justifies the exemption of the interest from the income tax which is imposed upon those who lend outside of Vermont.

In other words, the interest on the loan and the capital in which the loan is invested are said to be identical and it is pointed out that the capital tax on any tangible capital in which a Vermont loan is invested would exceed the income tax upon the interest upon an outside loan of the same size. His conclusion is that in some cases the interest on the Vermont loan has already borne its share of the burden due the state.

So far as we know, this is the first case where payment of a tax on capital has been urged as a justification for the exemption of the income upon that capital from an income tax which it would otherwise have to bear.

There is a case (*Hanover Insurance Co.* v. *Harding*, 272 U. S. 494 (1926) cited in our principal brief, p. 12), where it was urged that an ostensible exemption of a domestic insurance company from a net receipts tax, which was imposed on foreign insurance companies, was justified because in actual fact the net receipts of the domestic insurance company were taxed as part of the assets of the domestic insurance company. The tax on net receipts of foreign insurance companies was at the same rate as the tax on the assets of domestic insurance companies. On the other hand, the net receipts of foreign insurance com-

* Intangibles are tax exempt. (*Montpelier* v. *Gates*, 106 Vt. 116, 120, 170 Atl. 473 (1933). Cf. Appellee's brief, bottom of p. 24).

panies were assessed at full value and the assets of the domestic insurance companies, presumably containing their net receipts, were assessed at but 30% of the full value. This Court held that, while it might be true that the net receipts of the domestic insurance company were taxed as part of its assets, nevertheless, their under-assessment at 30% of the value worked a discrimination against a foreign insurance company whose net receipts were fully assessed at 100% of the value and that such discrimination was unconstitutional under the equal protection clause.

We assume that if the State of Vermont had been concerned in that case it would have made the same argument that it does here. That argument would have been as follows. The under-assessed net receipts are the same in substance as the capital of the company which earns them. Since the sum of the tax on that capital plus the tax on the under-assessed net receipts exceeds the tax on the fully-assessed net receipts, therefore the under-assessed net receipts bear their full quota of the burden due the state. The under-assessment is thereby justified.

In the *Hanover Insurance Co.* case, however, no one thought it worth while so to argue.

Income and the capital which produces it undoubtedly partake of one and the same substance, but that does not lead us into the absurdity that a mortgage for $1,000. is identical with the $50. interest due upon it. The $1,000. and the $50. are two different and separate sums. There thus would be good ground for argument that the payment of a capital tax on the *principal* of a loan could never be a justification for exempting the *income* thereon from an income tax which was assessed against the interest on other loans which had not been subjected to the capital tax.

The State's case here, however, is nowhere near as good as even that. The capital tax which is relied upon as a justification for the exemption of interest upon the borrowed money is not a tax assessed upon the borrowed money but a tax which *may be* assessed upon property purchased by the borrower if he *happens* to spend the bor-

rowed money in Vermont and *happens* to buy tangible property. No account is taken of the at least equal possibility that the fruits of the loan will go into non-taxable property as where they are used by a lumberman, quarryman or farmer as working capital to pay his expenses pending the production of his goods.

Even if the subject of the exemption could in every case be traced into the subject of the tax, however, that would not be enough. In order to justify the exemption there must be some logical relation between the tax which is imposed and the tax which is eliminated. This was pointed out on page 26 of our principal brief, and the case of *Bethlehem Motors Corporation* v. *Flynt*, 256 U. S. 421 (1921) was there cited and abstracted in support of our statement.

The link here between possible taxation of the debtor's hypothetical property and taxation of the creditor's actual income is too tenuous to constitute such a logical relation. In such a situation there is no room for the application of the rule laid down by Mr. Justice Holmes in *Klein* v. *Board of Supervisors*, 282 U. S. 19 (1930), cited in our principal brief at p. 23, that where property has already borne all but a small fraction of the burden due the state it may be exempted from tax without such exemption's constituting an illegal discrimination.* Under the rule of that case the interest upon an intra-state loan cannot be given exemption unless it has borne all but a fraction of the burden which the income tax imposes upon the interest on an extra-state loan. We find it difficult to compare the burden imposed by the income tax upon the interest on an extra-state loan with the burden which the interest on an intra-state loan may be said to have borne by virtue of the payment of a capital tax upon tangible property, which may have been purchased with the principal. The chain of

* Appellee's Brief (p. 26) states that this case approved the exemption of stock when the corporation had paid a local tax on but 75% of its property assessed at but *75% of its full value*. We believe that this represents a misconception of the opinion since we cannot conceive that Mr. Justice Holmes would have compared the part of the burden which the property had not borne to "a small fraction" (p. 23) if the Appellee's construction were correct.

cause and effect is too theoretical to serve as support for such an intensely practical matter as a tax.

The Commissioner's brief cites examples of statutes from other states where creditors have been exempted from taxation upon their credits. None of these examples involves an exemption from income tax. They are of two classes. The first of these classes is made up of general exemptions of creditors from capital taxation upon their credits without reference to locus. We can, of course, have no more quarrel with that than with Vermont's policy of not subjecting any intangibles to capital tax. The second of these classes involves the exemption of credits from capital taxation when secured by mortgages on real or personal property located within the state and when the mortgaged property is taxed at the same rate as the credit would have been if it had not been exempted. The obvious justification for such an exemption is to eliminate the subjecting of the same property twice to the same tax which inescapably occurs whenever a mortgage debt is taxed as against the mortgagee and the mortgaged property is taxed as against the mortgagor without deduction of the mortgage debt. The situation in the case at bar is far from anything of that sort. The tax eliminated is an income tax and the tax which the Commissioner says is paid is a capital tax. Thus, double taxation could not occur except in the limited sense that the taxation of capital and the taxation of the income therefrom is double taxation. Instead of property exempted from tax in the hands of A being sure to be subjected to a like tax in the hands of B, as in the case of the exemption of the mortgagee's interest in a mortgage, the best that the Commissioner can say in the case at bar is that a loan made in Vermont (the income of which is exempted from income tax) may, because made in Vermont, be invested in Vermont and may possibly be invested in the one class of property which is subject to a capital tax in Vermont, i. e., tangible property.

While the Commissioner's brief does not make the claim, we wish, for clarity, to point out that the interest exempted

from income tax by Public Act No. 17 does not represent income of the borrower upon which the borrower has paid a tax. Even if the borrower, as supposed by the Commissioner, invested what he borrowed in tangible property and even if he used that tangible property in his business to earn the interest, that interest so earned would not be subject to income tax in his hands. The debtor is expressly exempted from income tax upon it when he earns it by virtue of his right in computing his "business income" to deduct "all interest paid by the taxpayer during the income year".*

**The Commissioner's attempt to justify the exemption of Vermont dividends from taxation.**

The Commissioner's brief also uses the capital tax in an attempted justification of the exemption of extra-state dividends from income tax. The argument here is that even if the 2% tax on corporate earnings by itself does not justify the exemption from the 4% tax on dividends received, nevertheless, the 2% tax does constitute such a justification when we fortify it by adding to it the fact that the assets of the corporation earning the profits in Vermont may have been of a character subject to a capital tax in Vermont.

This very point might have been more forcibly made in *Hanover Insurance Co. v. Harding*, 272 U. S. 494 (1926, *supra*) and if correct, the *Hanover* case would have been decided differently and the under-assessment of the domestic insurance company for net receipts tax would have been sustained upon the ground that the tax paid by the domestic insurance company upon an under-assessment of all of its assets, including its net receipts, far exceeded the tax exacted from foreign insurance companies by a full assessment of their net receipts.

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*This exemption is contained in 1931 Public Act No. 17, Part I, Sec. 9, Subs. (b) as follows:

"Sec. 9. *Deductions.* In computing net income there shall be allowed as deductions:

* * * * * *

"(b). All interest paid by the taxpayer during the income year;"

In the case at bar, there is not even such a relation between the tax on the capital of the corporation and the tax on the income of the stockholder as existed between the two taxes in the *Hanover* case. This is true because the exempted income never bore any part of the capital tax when it formed part of the capital since nothing but tangible property is subject to capital tax in Vermont.*

In the case at bar, the Vermont earnings of a given corporation may have arisen from non-taxable intangibles, or from personal services, so that the corporation would pay little or no capital tax. If the dividends thus earned are exempted from tax as required by Public Act No. 17, neither the corporation nor the stockholders, nor even both together, bear their quota of the burden due the state, either by way of income tax or by way of capital tax. We add to this flaw the fact that the amount of dividends exempted depends upon the amount of business done by the corporation within Vermont during the year when the dividends are declared, not the year during which the dividends are earned. Taking all of these considerations together, the chances are very slim that the capital taxes paid by a corporation in any given year have any relation to the taxes on income received during that year from which the stockholders are exempted.

There remains the fact that the capital taxes paid are assessed upon capital, a different thing from income. In the *Hanover* case, this Court balanced the tax upon the net receipts of foreign insurance companies against the tax upon the net receipts of domestic insurance companies without throwing into the scale the taxes upon the capital of the domestic insurance companies. There is no more reason why the Court should do so here.

The capital taxes paid by corporations within Vermont are paid in consideration of the protection of that capital. The payment of such taxes does not entitle the enterprise to a line of credit at the State Treasury which may be used

* *Montpelier* v. *Gates*, 106 Vt. 116, 120, 170 Atl. 473 (1933). Cf. Appellee's brief, bottom of p. 24.

to justify a lesser income tax upon the stockholders of those corporations than upon the stockholders of outside corporations.

It has never been decided that a state might adopt a consistent policy of taxing, by way of capital tax, all intra-state wealth and of taxing, by way of income tax, all extra-state wealth of its citizens. Certainly if such a system were to be sustained, there would have to be a very close relation between the income tax and the capital tax in order to avoid an unconstitutional discrimination against other states. But the State of Vermont has not attempted that consistent policy here. Intra-state tangible real and personal property is subject to capital tax, yet the rents and earnings therefrom are subject to income tax.* Intra-state loans at more than 5% are subjected to income tax. The intra-state tangible property of corporations is subject to capital tax**, yet the earnings therefrom are subject to "franchise tax on corporations to be measured by net income."***

## CONCLUSION.

All that the Commissioner has done in pointing out that the intra-state borrower may use his loan to buy property on which he pays taxes and that the intra-state corporation may earn its dividends with property on which it pays taxes is to emphasize the correctness of the Vermont Supreme Court's view of the purpose of the Statute. That is that by discriminating against citizens' investment outside of the State, Vermont drives their investments into

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* 1931 Public Act No. 17, Pt. I, Secs. 5 and 6 as follows:

"Sec. 5. *Net income defined.* The words 'net income' mean the gross income of a tax payer less the deductions allowed by this act.

"Sec. 6. *Gross income defined; exemptions.* 1. The words 'gross income' include gains, profits and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business commerce, and net rental from real and personal property. * * *"

** Appellee's brief, bottom of p. 24.

*** 1931 Public Act No. 17, Pt. II, Secs. 2 and 3, quoted at Appellant's Brief, p. 5.

the State. The Commissioner says that one of the results of that is to increase the property within the State which is subject to capital tax. That general effect upon the Vermont tax situation is too remote from the income tax exemptions to meet the test that the exempted property, to sustain its exemption, must have borne its quota of the burden due the state. The real question in the case is the one squarely met by the Supreme Court of Vermont. That question is whether a policy of keeping Vermont capital in Vermont is a sufficient justification for an income tax law which exempts Vermont income and taxes outside income. We submit that there can be no justification for such a law since it works a clear and hostile discrimination which abridges the privileges and immunities of citizens of the United States and deprives them of the equal protection of the laws.

**Note as to Appellee's treatment of Appellant's Point IV.**

The Commissioner's brief is in error in stating (p. 33) that there is no proof in the case that the Appellant's wife did not use the $800. exemption which he claims. While a small matter, this deserves correction.

The agreed statement of facts (R. 14) contains the following statement (R. 11, italics ours):

> "8. That said tax was computed without the benefit of a personal exemption of $800.00 *to which the taxpayer would have been entitled* as a married individual living with his wife but for the fact that he received during said year an amount of Class A income, so-called."

Respectfully submitted,

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